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, ID No.

Taxpayer =

State A =

Coop =

Dear _____ :

This is in response to a request for rulings submitted by your authorized representatives concerning the federal income tax consequences of a transaction involving a subchapter T cooperative as described below.

Taxpayer is the surviving entity resulting from the merger of two entities. Taxpayer is a State A corporation organized and operating under the State A Business Corporation Act and the State A Co-operative Act.

Taxpayer is managed by a Board of Directors consisting of _____ individuals. Taxpayer operates under several divisions which are designated based on the scope,

activities, product coverage, operational and geographical coverage, and which are more specifically set forth in the Plan of Operations.

Currently, Taxpayer has two types of members, Shareholder Members and Associate Members (collectively, the "Members"). The right and obligations of the Members are set forth in the By-laws. All members must own a business that is operated in compliance with Taxpayer's By-laws and Plan of Operations pursuant to an accepted application for membership. Taxpayer has two classes of stock, Class A shares and Class B shares (collectively, the "Shares"). No person is permitted to own more than one Class A share. A Shareholder Member is a Member of Taxpayer that owns one share of the Class A shares. Associate Members have all of the rights, privileges, duties, and obligations of Shareholder Members except the ownership of Class A shares and the rights attendant thereto. Each outstanding Class A share and each outstanding Class B share is entitled to vote on acts of Taxpayer. The voting power of the Class A shares changes annually based on the annual purchases of products by the Shareholder Member. Each Class B share is entitled to one vote only upon certain matters requiring a vote by the Shareholders under applicable law or pursuant to the Articles of Incorporation.

Taxpayer created the Class B shares in and allocated the initial Class B shares to the then Members based on their patronage over the proceeding year period. Taxpayer issued additional Class B shares from time to time, which it has allocated to the Members based on their patronage over the applicable time period. Upon termination of membership for any reason, a holder's Class A share is automatically redeemed for its par value of \$, and any Class B shares repurchased by Taxpayer in accordance with the terms and conditions provided in the Plan of Operations, which generally provides that the shares are redeemed at book value.

Taxpayer's Articles of Incorporation prohibit Taxpayer from paying dividends with respect to any of its shares. Specifically, Article Four of the Articles of Incorporation, as amended, provides that "[N]o dividends shall be declared or paid with respect to any Shares of the Corporation." The Articles of Incorporation further provide that Taxpayer shall distribute its rebateable net income to qualified participants in the form of patronage rebates as provided in its By-laws, and that, upon dissolution of Taxpayer, each Class A share shall receive a distribution equal to its par value of \$ per share, and thereafter, the Class B shares shall receive a distribution equal to a pro rata portion of the net assets of the corporation remaining after the claims of all creditors have been satisfied and payment of patronage distributions have been made or provided for.

Article IX of Taxpayer's By-laws provide that Taxpayer shall rebate to its "Qualified Participants" at least annually all of the corporation's rebateable net income in excess of such reasonable retentions for reserves, payments of debts, capital improvements, or additions and working capital requirements, as the Board of Directors may determine. For this purpose, net gains resulting from the sale or exchange of

tangible or intangible assets used in Taxpayer's business are not included in Taxpayer's rebateable net income. Historically, Taxpayer distributed substantially all of its net earnings as patronage rebates to its Members. If Taxpayer's operations for any division result in a loss, the By-laws permit the Board of Directors to levy a deficit charge against Qualified Participants or to net the loss against patronage rebates otherwise payable to the Qualified Participant. There is no provision which permits an assessment of losses to a former Member.

Article IX of Taxpayer's By-laws define a Qualified Participant as a Member who is or was participating in a division of Taxpayer on or prior to the designated date on which qualification for receipt of patronage rebates (the "Qualified Date") is determined by the Board of Directors. The By-laws further provide that a former Member shall not be a Qualified Participant of any division if the Member has been expelled for cause, or if the Member's membership has terminated prior to the Qualification Date by voluntary resignation or termination not in compliance with the requirements of the By-laws or Plan of Operations or not incidental to a bona fide sale, liquidation, termination, or insolvency of his or her business. Thus, a former Member that would otherwise be entitled to a patronage rebate will not receive one if the Member is expelled or terminates membership in a manner that triggers this provision of the By-laws despite having participated in a division of the Taxpayer prior to termination. Members that terminate membership in a manner that is not in violation of this provision of the By-laws will be paid their share of patronage rebates with respect to their patronage prior to the termination date, and any of their Class B shares will be redeemed by Taxpayer in accordance with the above-described terms, but the Members will have no right to receive any additional patronage rebates or other payments subsequent to that date.

Article IX of the By-laws provides that patronage rebates are payable wholly in cash or payable in a combination of cash, property, Rebate Notes, Class B shares, or other form of written notice of allocation within the meaning of Section 1388(b) of the Code; provided, however, that at least 20% of patronage rebates for each year must be paid in cash and provided further that the percentage payable in Rebate Notes and Class B shares or other form in written notice of allocation shall be uniformly applied to all Members. The Rebate Notes bear interest at a rate equal to the interest rate that is designated by the Board of Directors as the applicable rate under the Plan of Operations for purposes of voluntary loans made by Members, and are payable in five equal annual installments, beginning on _____ of the first fiscal year following the fiscal year in which the Rebate Note is issued and on _____ of each of the four succeeding fiscal years thereafter. The By-laws further provide that each Member consents that the amount of any patronage rebate payable in the form of a Rebate Note, Class B shares, or other written notice of allocation shall be included in the gross income of the Member at its stated dollar amount in the taxable year in which the Rebate Note, Class B share, or other written notice of allocation is received by the Member

Each member agrees to purchase from Taxpayer not less than a minimum dollar amount of merchandise each week as specified in the Member's application for membership. In furtherance of this requirement, Members are required pursuant to the Plan of Operations to maintain a security deposit with Taxpayer in the form of a standby letter of credit or cash deposit. A Member that has terminated membership for any reason is generally entitled to a return of the security deposit within 90 days following the termination. In the event of any liquidation, dissolution or other winding up of Taxpayer, no portion of the security deposits, Rebate Notes or other amounts specified in the Plan of Operations as being owed to Members shall be returned or paid to the Member unless and until all principal and interest on all other liabilities, debts and indebtedness of Taxpayer shall be been paid and satisfied in full.

Taxpayer is organized and operated as a cooperative that serves member retail located in the . Taxpayer was originally formed as a buying cooperative and aims to provide the independent retailer with product, prices, and services to keep the retailer competitive with the major chains. In addition to its buying activities, Taxpayer provides advertising support, store building programs, training programs, and various other support services to its members. Taxpayer's inventories consist principally of purchased goods held for resale to members, including and general merchandise.

Taxpayer owned and operated a warehouse located in which had been used by the Taxpayer as its primary warehouse and distribution center since . Taxpayer's business office was in a separate building on the property adjacent to the warehouse, which was separately built at a later date. On , Taxpayer entered into a contract to sell all of its buildings and related land (collectively, the "Property") to an unrelated investment group (the "Purchaser"). The sale of the property was effectuated on (the "Effective Date"), for a purchase price of approximately \$ million. The Taxpayer subsequently leased back from the Purchaser the office building and a portion of the warehouse for a term of months for annual rent of \$ (the "Lease"). Taxpayer had an adjusted tax basis in the Property of approximately \$ on the Effective Date, resulting in gain before related selling expense of approximately \$ on the sale ("Gain"). Taxpayer proposes to distribute the net proceeds from the sale of the Property (the "Proceeds") to its Members as a patronage dividend, with at least 20% of the dividends to be paid in cash, with the remainder to be paid in the form of qualified written notices of allocation.

Taxpayer's Board of Directors approved the sale of the Property as part of an overall strategic plan to improve efficiencies in the operation of the business, and to allow for more flexibility in connection with options regarding the future operation of the business. Specifically, Taxpayer's Board of Directors believed that the Property was too large and too expensive to support in light of Taxpayer's current business activities. In

addition, Taxpayer and its Members were considering certain options including ceasing operations or merging operations with another cooperative. At this time, Taxpayer intends to wind down operations following expiration of the Lease. Taxpayer has entered into a transition agreement with a separate cooperative, Coop, to purchase certain of Taxpayer's inventory and assets, and most Members have signed agreements to become members of Coop upon the eventual winding down of Taxpayer's operations.

Taxpayer proposes to distribute Proceeds to its current Members in good standing as of the end of Taxpayer's fiscal year in which the Effective Date of the sale occurred (i.e., (the "Allocation Date")), based on the Members' patronage over Taxpayer's approximate -year holding period of the Property (the "Holding Period"). Members who withdrew from the cooperative prior to the Allocation Date will not receive any distribution of Proceeds related to the Property even if the Member had patronage activities during the Holding Period.

Taxpayer believes that its proposed allocation method is appropriate because: (i) Taxpayer has computerized records that accurately track membership and patronage for the last fiscal years, and can compile paper records and verify that the paper records accurately track membership and patronage with respect to current Members for the preceding fiscal years during the Holding Period; (ii) Taxpayer's membership has been relatively stable over the Holding Period; (iii) the majority of the current Members have been Members for many years prior to the Allocation Date, including many who have been Members throughout the Holding Period; (iv) the current Members that would be entitled to the largest allocations have been Members for many years prior to the Allocation Date, including many who have been Members throughout the Holding Period; (v) a number of patrons have withdrawn from the cooperative throughout the Holding Period, and the administrative burden of tracking down such former Members would be material; (vi) inclusion of former Members would significantly increase the amount of Proceeds that would be unclaimed, inasmuch as many former Members are no longer in business; (vii) under Taxpayer's organizational documents, former Member no longer have a current financial interest in Taxpayer; and (viii) Taxpayer expects to cease operations, and it would be inequitable to permit long departed Members that will not be required to bear any costs associated with winding down the business to share in Proceeds. In support of its position, Taxpayer represents the following:

1. Taxpayer has computerized records that accurately track membership and patronage for the fiscal years through . For years prior to , Taxpayer maintained paper records. Taxpayer can compile those paper records with respect to its current Members, and can verify with those current Members that the paper records accurately track the Member's membership and patronage for the applicable years that the current Member was a Member during the Holding Period. With respect to former Members, many of

- whom no longer exist, and would be difficult, if not impossible, to identify and locate, Taxpayer would be unable to verify the accuracy of the paper records.
2. Taxpayer's membership over the Holding Period has been relatively stable. Most current Members have been patrons of Taxpayer for many years prior to the Allocation Date. Taxpayer can identify its Members as of the Allocation Date and can track and verify their patronage throughout the Holding Period. Taxpayer's records show that the stores operated by current members that would be entitled to a distribution under Taxpayer's proposed method account for approximately % of the total sales volume during the year period for which it has maintained computerized records, and that the average annual sales volume for the Members throughout the entire Holding Period do not differ significantly.
 3. Taxpayer's records show that inclusion of former Members that left the cooperative prior to the Allocation Date would have a small effect on how proceeds would be distributed both because the dollar volume of patronage dividends has generally been larger in more recent years and because the current Members that would be entitled to the largest distributions have been patrons of Taxpayer for many years prior to, and including the Allocation Date. As stated in representation 2, current Members account for approximately % of Taxpayer's total sales volume over the most recent fiscal years.
 4. Analysis of Taxpayer's records shows a number of patrons have withdrawn from the cooperative during the Holding Period. Many of those former Members no longer exist, and would be difficult, if not impossible, to identify and locate them.
 5. Once a ceases to buy goods and use the services provided by Taxpayer, membership is terminated, the Class A share is automatically redeemed, and the Class B shares are repurchased by Taxpayer pursuant to the terms of the Plan of Operations as described above. The By-laws provide that a former Member is no longer a "Qualified Participant" and is not entitled to any patronage rebates attributable to the time period after termination, and can no longer be assessed for any losses Taxpayer may incur. In addition, a former Member that is expelled, voluntarily terminates its interest, or terminates in such a manner that is not in accordance with the By-laws or the Plan of Operations, is not entitled to any patronage rebates even with respect to the time period prior to termination. A former Member's only interest in the cooperative is represented by any Rebate Notes held by the Member, which will be retired after the 5-year period described above (none of which are outstanding). Thus, Members whose membership has terminated have no

further financial interest or property rights in Taxpayer subsequent to the termination.

6. Taxpayer sold the Property as part of an overall strategic plan to improve efficiencies in the operation of the business, and to allow for more flexibility in connection with options regarding the future operation of the business. Taxpayer intends to cease operations following expiration of the Lease (the "Termination"), pursuant to which Taxpayer will sell other assets and inventory, and its Members will join other cooperatives. Also as part of the Termination, Taxpayer will incur significant expenses, including a required funding of Taxpayer's underfunded pension liability. Because Taxpayer's organizational documents provide that a former Member can no longer be assessed for any losses, Taxpayer's Termination expenses will be borne entirely by its current Members.

Taxpayer further represents that its Bylaws and Articles as well as State A law, require it to distribute the Gain related to the sale of Taxpayer's Property to Taxpayer's patrons.

Based on the foregoing, Taxpayer requests the following rulings:

1. The gain from the sale of the Property represents patronage source income under the Code and § 1.1382-2(b)(1) of the regulations.
2. The method of distributing the Proceeds in the form of patronage dividends resulting from the Gain in accordance with the above-described procedures is practicable and a reasonable method of distributing the Proceeds to the persons who were patrons during the taxable years in which the Property was owned, and the amounts paid by Taxpayer to its Members will be deductible as patronage dividends under § 1382(b)(1) of the Code and § 1.1382-2(b)(1) of the regulations.

Section 1388(a)(3) of the Code specifies that a patronage dividend must be "determined by reference to the net earnings of the organization from business done with or for its patrons." That section further provides that the term "patronage dividend" does not include any amount paid to a patron to the extent that such amount is out earnings other than from business done with or for patrons. Further, it does not include earnings from business done with or for other customers "to whom no amounts are paid, or to whom smaller amounts are paid with respect to substantially identical transactions."

In Rev. Rul. 69-576, 1969-2 C.B. 166, a nonexempt farmers' cooperative borrowed money from a bank for cooperatives (itself a cooperative) to finance the acquisition of agricultural supplies for resale to its members. The bank for cooperatives

allocated and paid interest from its net earnings to the nonexempt farmers' cooperative which it in turn allocated to its members.

In determining whether the allocation was from patronage sources the ruling states:

The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources. Rev. Rul. 69-576 at 167.

The ruling concluded that in as much as the income received by the nonexempt cooperative from the bank for cooperatives resulted from a transaction that financed the acquisition of agricultural supplies which were sold to its members, thereby directly facilitating the accomplishment of the cooperative's marketing, purchasing, or service activities, the income was patronage sourced.

Section 1.1382-3(c)(2) of the Income Tax Regulations defines income from sources other than patronage (nonpatronage income) to mean incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association such as income derived from lease of premises, from investment in securities, or from the sale or exchange of capital assets.

In *St. Louis Bank for Cooperatives v. United States*, 224 Ct. Cl. 289, 624 F.2d 1041 (Cl. Ct. 1980), the Court held that interest on demand deposits in farm credit banks or on loans to brokerage funds received by St. Louis Bank for Cooperatives was patronage sourced income. The Court stated that a particular item of income is patronage sourced when the transactions involved are directly related to the marketing, purchasing, or service activities of the cooperative association. 624 F.2d at 1045.

In *Twin County Grocers, Inc. v. United States*, 2 Cl. Ct. 657 (1983), a nonexempt cooperative was denied deductions for patronage dividends for interest on a certificate of deposit bought from a nonpatron bank because the dividend income was not patronage sourced. The Court held that the relation of income activity to the cooperative's business was too tenuous.

Courts have ruled in several instances that income from corporations organized by cooperatives to conduct activities related to the cooperative business is patronage

sourced. In *Farmland Industries v. Commissioner*, 78 T.C.M. 846, 864 (1999), *acq.*, AOD 2001-03 (citing *Cotter & Co. v. United States*, 765 F.2d 1102, 1106 (1985); *Land O'Lakes, Inc. v. United States*, 675 F.2d 988, 993 (8th Cir. 1982); *Certified Grocers of Cal., Ltd. v. Commissioner*, 88 T.C. 238, 243 (1987); *Illinois Grain Corp. v. Commissioner*, 87 T.C. 435, 459 (1986)), the taxpayer, a cooperative organized for the purpose of providing petroleum products to its patrons, sought to have the proceeds from the disposition of its stock in three subsidiaries classified as patronage-sourced income. In reaching its decision, the Court stated that its task was to “determine whether each of the gains and losses at issue was realized in a transaction that was directly related to the cooperative enterprise, or in one which generated incidental income that contributed to the overall profitability of the cooperative but did not actually facilitate the accomplishment of the cooperative=s marketing, purchasing, or servicing activities on behalf of its patrons.” 78 T.C.M. at 870.

In *Land O'Lakes, Inc.*, *supra.*, the Court held that dividends received by the nonexempt cooperative from the St. Paul Bank for Cooperatives was patronage derived and could be allocated to Land O'Lakes patrons as deductible patronage dividends. The Court noted that the taxpayer was required to acquire and hold the stock to obtain a loan, the proceeds of which were used to finance cooperative activities on favorable terms finding that the subject transaction was not significantly distinguishable from the transaction in Rev. Rul. 69-576.

Section 1.1382-3(c)(3) of the regulations provides in relevant part, that it is necessary that the amount sought to be deducted be paid on a patronage basis in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such income is attributable. For example, if capital gains are realized from the sale or exchange of capital assets acquired and disposed of during a single taxable year, income realized from such gains must be paid to patrons of such year in proportion to the amount of business done by such patrons during the taxable year. Similarly, if capital gains are realized by the association from the sale or exchange of capital assets held for a period extending into more than one taxable year, income realized from such gains must be paid, insofar as is practicable, to persons who were patrons during the taxable years in which the asset was owned by the association in proportion to the amount of business done by such patrons during such taxable years.

In the instant case, the Property was used in the Taxpayer's business to warehouse and facilitate the efficient distribution of its products to its members. Taxpayer's Board of Directors approved the sale of the Property as part of an overall strategic plan to improve efficiencies in the operation of the business, and to allow for more flexibility in connection with options regarding the future operation of the business. Specifically, Taxpayer's Board of Directors believed that the Property was too large and too expensive to support in light of Taxpayer's current business activities. In addition, Taxpayer and its Members were considering certain options including ceasing

operations or merging operations with another cooperative. Hence, the sale was also directly related to and facilitative of Taxpayer's cooperative purpose.

Accordingly, based solely on the foregoing we rule that:

1. The Gain from the sale of the Property represents patronage source income that may be eligible for a patronage dividend exclusion under § 1382(b)(1) of the Code and § 1.1382-2(b)(1) of the regulations.
2. The method of distributing the Proceeds in the form of patronage dividends resulting from the Gain in accordance with the above-described procedures is practicable and a reasonable method of distributing the Proceeds to the persons who were patrons during the taxable years in which the Property was owned, and such amounts paid by Taxpayer to its Members will be deductible as patronage dividends under § 1382(b)(1) of the Code and § 1.1382-2(b)(1) of the regulations.

This ruling is directed only to the taxpayer that requested it. Under § 6110 (k)(3) of the Code it may not be used or cited as precedent. In accordance with a power of attorney filed with the request, a copy of the ruling is being sent to your authorized representatives.

Sincerely yours,

Nicole R. Cimino

Nicole R. Cimino
Senior Technician Reviewer, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

cc: